



**CUSTOMS UNION  
BETWEEN BELARUS, KAZAKHSTAN AND RUSSIA:  
POTENTIAL IMPACT ON KYRGYZSTAN AND TAJIKISTAN**  
*(DRAFT AS OF MAY 16, 2011)*

*Ekaterine Vashakmadze, Bartłomiej Kaminski, and Yulia Mironova*

Poverty Reduction and Economic Management Unit,  
Europe and Central Asia Region, World Bank

# Key messages

- Kyrgyzstan's and Tajikistan's economic welfare heavily depends on conditions in access to BKR markets for goods, labor and capital;
- The change in these conditions triggered by the adoption of common external tariff and moves towards establishing a common economic border has affected exports of both countries to Kazakhstan
- The impact is a double edge sword:
  - In the near term, it may have a hugely negative impact on Kyrgyz export;
  - In the mid term, it may have a positive impact on exports of goods from both Kyrgyz Republic and Tajikistan.
- ... but the impact hinges critically on the supply response in two countries and the future evolution in BKR integration

# Outline of the presentation:

- I. Uniqueness of Kyrgyzstan's and Tajikistan's linkages with Belarus, Kazakhstan and Russia (BKR CU)
- II. Customs Union's new trade policies and their significance for Kyrgyzstan and Tajikistan
- III. Digression on channels of trade in Central Asia
- IV. Vulnerability of Kyrgyz Republic to the changes in existing conditions in access to Kazakhstan's markets for goods;
- V. Assessment of potential economic impact of the Customs Union on exports of goods from Kyrgyzstan and Tajikistan
- VI. Policy implications

BKR linkages to Kyrgyzstan and Tajikistan are much more important to their welfare than those with the ROW (rest of world)

- ❑ Linkages embrace not only trade in goods but also include factors of production—labor and capital:
  - ❑ Reported ***remittances transferred from Russia to Kyrgyzstan and Tajikistan*** accounted for approximately 17 percent and 25 percent, respectively, of their GDP in 2009;
  - ❑ Russian and Kazakhstan are also ***major foreign investors*** in Kyrgyzstan and Tajikistan.
- ❑ But trade in goods is also special for two reasons:
  - ❑ its large part moves ***through non-standard channels***;
  - ❑ Kyrgyzstan's and Tajikistan's BKR-destined exports have ***more positive welfare effects than exports to the ROW***.

# Uniqueness of BKR-destined exports stems from their following features:

- ❑ ***Their size:*** these markets take more than half of their total exports of goods (excluding gold for Kyrgyz Republic and aluminum for Tajikistan);
- ❑ They are ***much more diversified*** compared to the ROW-exports which are dominated by gold for Kyrgyzstan and aluminum and cotton for Tajikistan (see next slide);
- ❑ They contain a much ***larger share of labor intensive goods*** and, therefore, contribute heavily to reducing unemployment and poverty in both countries.
- ❑ Last but not least, they are significantly larger than indicated because of ***huge unreported trade going through non-standard channel*** (see the slide further on).

## Salient features of Kyrgyzstan's and Tajikistan's officially recorded exports to the BKR CU

<b>Kyrgyzstan</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
Share of BKR in total exports	40.0	38.9	30.9	26.1
Share of BKR in exports excluding gold	54.0	48.5	43.3	47.5
Share of gold in total exports	25.9	19.8	28.6	44.9
Share of gold in non CIS-destined exports	49.4	39.5	54.8	77.8
Concentration of BKR-destined exports (values of H-H index)	348	284	367	345
Concentration of ROW-destined exports (values of H-H index)	2,237	1,815	3,069	4,100
Share of agricultural foods and feeds in BKR-destined exports	56.3	54.8	47.2	54.2
<b>Tajikistan</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
Share of BKR in total exports	17.6	18.0	24.5	28.1
Share of BKR in exports excluding aluminum	49.8	54.6	52.8	60.1
Share of aluminum in total exports	64.8	67.3	56.4	53.9
Share of aluminum in non CIS-destined exports	78.6	81.9	72.7	74.4
Concentration of BKR-destined exports (values of H-H index)	2,382	1,711	1,320	1,173
Concentration of ROW-destined exports (values of H-H index)	5,894	6,177	4,307	4,379
Share of agricultural foods and feeds in BKR-destined exports	94.9	95.0	90.3	95.7

## Establishment of Customs Union on January 1, 2010: what's new for exporters from Kyrgyzstan and Tajikistan?

- ❑ Two changes in market access for Kyrgyz and Tajik exporters:
  - The termination by the government of Kazakhstan of a simplified customs procedure applied to 'bazaar goods,' i.e., non-standard trade as a step towards harmonizing its border controls with those of other CU members;
  - The adoption of CET (Common External Tariff) combined with the continuation of free trade regime for CIS countries;

# Implications of Kazakhstan 's more restrictive customs regime on shuttle or 'suitcase' trading combined with more restrictive rules of origin:

- Regime governing exports through non-standard channel before- and after-CU.
  - **Before the CU:** A single custom fee (i.e. including VAT) of €0.6 per 1 kg for the light industry goods and 13 percent of import value for fruits and vegetables. The weight of the goods was not to exceed two tons and the value US\$10 thousand.
  - **Under the CU:** A general regime with ad valorem tariff rates of 10 to 20 percent, but not less than €1-4 per kg depending on the product. Thus, the ad valorem component of a compound tariff rate doubled and the specific one increased by at least 61 percent.
- While the potential **for losses is huge** (see next slides) , they are difficult to estimate as it remains to be seen how traders on both sides of the border are going to adjust to new regulations.
- But it seems that re-export activities in Kyrgyzstan are not likely to be completely eradicated. Consider that
  - the imposition of a very unfriendly regime towards imports of goods from neighboring countries by the Government of Uzbekistan has curbed this trade but not wiped it out;
  - Re-exports fell in 2010 , bur they also fell in 2009 and the contraction in 2010 coincided with the Second Revolution and the closure of border with Kazakhstan.



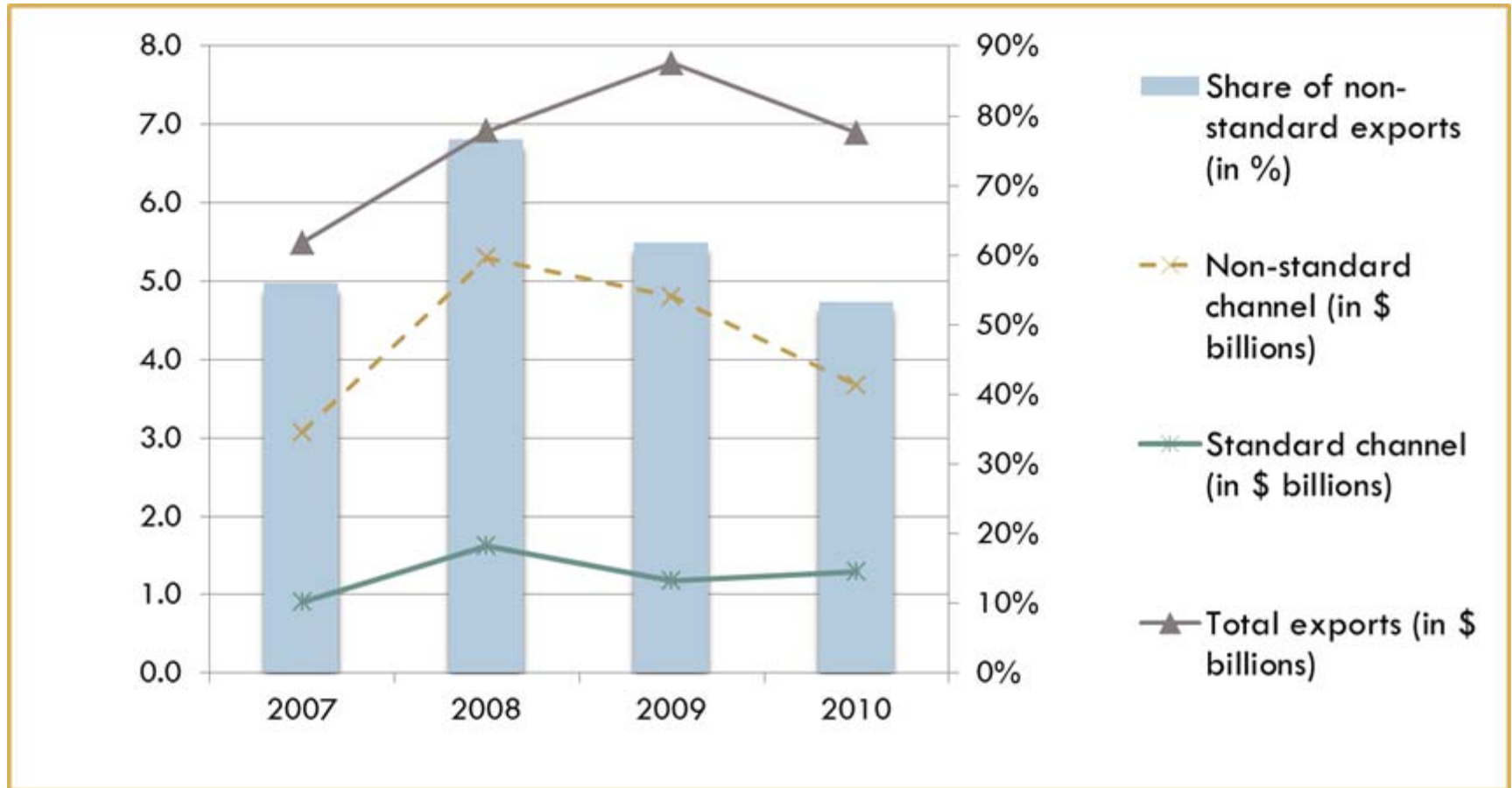
# Channels of foreign trade in Central Asia: significance of non-standard channel for Kyrgyz Republic

- Foreign trade of Central Asian economies may be characterized as occurring through two distinct channels:
  - formal or standard trade, which is mainly based on railroads as a mode of transportation, and including such bulk products as oil and gas or metals trade, or trade flows in equipment goods or machinery;
  - non-standard trade, i.e., carried on by small traders subject to simplified procedures of imports or smuggled, and therefore difficult to assess, and including also cross-border trade, i.e., trade in mainly locally produced goods within 30 kilometers from border.
- Two groups of products move through non-standard channel:
  - *consumer products imported from outside Central Asia* mainly from China but also from Turkey, India, Iran, and South Korea. They are either directly consumed in a country of destination or re-exported. Their magnitudes can be only estimated indirectly from analyses of foreign trade statistics;
  - *locally produced agricultural and industrial goods* including clothing manufactured in Kyrgyzstan and recently probably also in Tajikistan.
- Kyrgyzstan is a major broker in “a” goods and a large exporter of “b” with their share in total exports above 50% (see Figure on the next slide).
- **Note: since Tajikistan does report its trade data to the UN database, it is impossible to estimate its exports through non-standard channel**

## Kyrgyzstan (presumably also Tajikistan) is particularly vulnerable to any changes affecting non-standard exports

- Kyrgyz exports through non-standard channel are larger than total exports (including gold) as shown in Figure below;
- Re-exports accounted for 86% of non-standard exports down from 93% in 2008 (see Table below);
- Clothing made in Kyrgyzstan accounted for 14% in 2010 up from 7% in 2008 and fruits and vegetables stayed flat at around 3%;
- BKR consumers accounted for around 83% of total non-standard exports in 2006-10;
- Re-exports are a source of revenue adding around 10% to the value of imports;
- Therefore,... if re-exports of bazaar goods from Kyrgyzstan are completely shut down, welfare loss may amount to at least around six percent of the GDP.
- .... however, since non-standard exports of clothing 'Made in Kyrgyz Republic' may shift to standard exports channel, they may not be affected by the change in access to BKR markets through non-standard channel.

Kyrgyz exports through non-standard channel peaked in 2008 but their value in 2010 was still above standard exports and above its level in 2007



## Estimates of Kyrgyz exports through non-standard channel in 2008-09

	2008	2009	2010
	<b>In millions of current US dollars</b>		
<b>Estimated re-exports of "bazaar" goods (including mainly clothing, footwear, fabrics, construction materials)*</b>	<b>8,127</b>	<b>4,189</b>	<b>3,091</b>
Estimated exports of Kyrgyz apparel through non-standard channels (our estimate minus reported by partners)	632	461	487
<b>Estimated exports of fruits and vegetables through non-standard channel (reported by partners minus official)**</b>	<b>213</b>	<b>154</b>	<b>95</b>
<b>Flows of goods through non-standard channels (total above)</b>	<b>8,759</b>	<b>4,650</b>	<b>3,579</b>
of which flows of goods destined to Kazakhstan and Russia (through Kazakhstan)***	7,221	3,873	2,958

*For notes see next slide*

Source: WB staff estimates based on data from the UN COMTRADE database.

## Notes to Table above

- \* Includes value added of 8 percent and cost of freight of 2 percent;
- \*\* There is a huge discrepancy between reported by Kyrgyzstan exports of fruits and vegetables and mirror statistics for Russia only among all other trade partners, therefore we assume that all non-standard exports of fruits and vegetables go to the Russian market;
- \*\*\* Based on the estimate flows intermediated by Karasuu bazaar in Southern Kyrgyzstan: it serves as a hub for re-exports to Uzbekistan and Tajikistan taking jointly around 20 percent of re-exports of goods and assuming that the rest is channeled through Dordoi (derived from Kaminski and Mitra, 2010).

# Implications of CET for exports originating in Kyrgyzstan and Tajikistan:

- ❑ Improved access to Kazakhstan's markets and no change in Russian or Belarus markets because Kazakhstan's MFN tariff rates increased as a result of adopting the CET (see next slide) while Russia's and Belarus' tariff rates for products imported from Kyrgyzstan and Tajikistan remained roughly the same. In consequence,
- ❑ Since Kazakhstan's MFN tariff rates increased as a result of adopting the CET, while suppliers from Kyrgyzstan and Tajikistan (as well as from other CIS countries) continue having duty-free access, **preferential tariff margins, i.e., the difference between MFN and preferential tariff rates, increased** making them more competitive vis-à-vis non-preferential suppliers (see next slide)
- ❑ Hence, all things unchanged, **as long as the BKR CU does not revoke CIS free trade agreements, Kyrgyz and Tajik exports can only increase with the size of the increase depending on their supply response and competitiveness vis-à-vis other CIS exporters.**

# Characteristics of Kazakhstan's MFN tariff schedule before and after joining the CU

- Higher trade protection:
  - ▣ Simple average applied MFN tariff rate has increased from 6.7 percent in 2009 to 11.1 percent (with transition rates) and to 11.5 percent (without transition rates) in 2010
  - ▣ Weighted average applied MFN tariff has increased from 5.3 percent in 2009 to 9.5 percent (with transition rates) and to 10.4 percent (without transition rates) in 2010
- Less uniform tariff structure
  - ▣ Dispersion of tariff rates measured by standard deviation of simple average tariff rates has increased from 9.8 to 15.9
  - ▣ Dispersion of weighted average rates has increased from 8.3 to 11.4
- MFN applied tariff rates have increased the most for the following sectors:
  - ▣ wearing apparel, dressing and dyeing of fur by 10.4 percentage points;
  - ▣ motor vehicles by 19.4 percentage points;
  - ▣ forestry by 9.8 percentage points;
  - ▣ furniture by 8.83 percentage points .

*Note: Comparison of tariffs is based on Oleksandr Shepotylo, "Calculation of the tariff rates of Kazakhstan before and after the imposition of the customs union common external tariff in 2010", World Bank (2011). Jensen, J. and D.G. Tarr, 2011, "Kazakhstan in the Customs Union: Can Gains from Improved Trade Facilitation and Reduction of Non-Tariff Barriers Overcome the Losses from Higher Tariffs?" World Bank, study financed by the WB-GoK JERP., led by Ekaterine Vashakmadze.*

## **Estimates of potential increases Kazakhstan-destined exports: Method 1** (products with exports exceeding US\$500,000 on average in 2007-09 and for which the tariff protection increased under CET and the share of non-CIS suppliers in Kazakhstan's imports exceeded 10 percent)

### **Kyrgyzstan**

- Conditions of access vis-à-vis non-CIS exporters improved with the entry of the CET for 35 percent of exports to Kazakhstan or 10 percent of the total including gold.
- Weighted preferential margin over non-CIS exporters increased from 3 percent to 10 percent ad valorem; and for 13 percent of Kazakh-destined Kyrgyz exports the increase was equal to or exceeded 10 percent, i.e., non-CIS suppliers now have to have at least a ten percent edge over CIS suppliers in comparison to tariff conditions under the old Kazakh tariff schedule

### **Tajikistan**

- Total Tajik exports of products, which gained 10 percent or more in preferential margins, accounted for two-thirds of total Kazakh imports from Tajikistan.
- The weighted preferential margin for these exports more than doubled from 6 percent to 13 percent offering some room for an increase in exports – currently only 5 percent of total Tajik Kazakhstan-destined exports were identified as “stable”.



## Estimates of potential increases Kazakhstan-destined exports: Method II (industrial products successfully exported to Russia (but not in Kazakhstan) under tariff protection comparable to the one under the CET and, therefore, having capacity to expand sales in Kazakhstan after the entry into force of the CET)

- The potential for an increase of industrial products already competitive in Russia appears **to be much larger for Tajikistan than for Kyrgyzstan** because the latter's penetration of Kazakhstan markets is much deeper and more extensive than that of Tajikistan.
- Assuming that exporters reach the same share in Kazakhstan's total imports as they had in Russia, **Tajik exports** of industrial products to Kazakhstan could increase around US\$350 thousand, which is an equivalent of 6 percent of their total Kazakhstan-destined exports of industrial products excluding electricity.
- Hence, the ***adoption of a CET*** resulting in the increase of tariffs in Kazakhstan ***will not have negative impact on exporters in Kyrgyzstan and Tajikistan.***
- To the contrary, if anything, this may boost their exports. The potential for growth of exports to Kazakhstan is very significant: ***whether it will be tapped depends, among other things, on the ability of firms to respond to new competitive conditions and on the ability of the Governments to provide right incentives to those firms.***

# Policy Implications

- ❑ Since preferential margins vis-à-vis MFN suppliers have improved not only for Kyrgyz or Tajik products but also originating in other CIS countries, possible gains in market share cannot be taken for granted.
- ❑ Therefore, the challenge for policy makers is to find ways to ensure that their respective business environment
  - a. facilitates the supply response of the private sector to new exports opportunities created by the introduction of the CET;
  - b. and makes private businesses out-compete suppliers from other CIS countries in Kazakhstan's markets
- ❑ The design of supportive policy calls for the **identification of barriers that might hamper the supply response of sectors** that stand to benefit most from the surge in preferential margins in Kazakh markets.
  - a. Once these barriers are identified, appropriate policy measures to alleviate them might be introduced.
  - b. This calls for actions in several analytical and policy areas ranging from sectoral analyses to policy measures shaping domestic business environment, the cost of doing business and the cost of foreign trading.

# Policy Implications continued ....

- The ***sector that requires particular attention of the government of Kyrgyzstan is clothing and apparel*** for two reasons:
  - First, the extent to which the development of this sector has led to vertical spillovers through backward linkages is not known.
    - a. If there are no vertical spillovers, then one should pinpoint the reasons and take policy action to provide incentive to develop them.
    - b. The knowledge and the existence of backward linkages would strengthen the validity of Kyrgyz certificates of origin, as this would make easier fending off allegations of inadequate domestic input to obtain preferential access to BKR markets.
  - *Second*, the emergence of Kyrgyzstan as a regional powerhouse has important development policy lessons not only for Kyrgyz and Tajik authorities but also for other developing countries. Consider the following:
    - a. The sector emerged and flourished facing ‘almost duty-free’ competition from Chinese imports rather than behind the wall of trade protection.
    - b. Its development has been made possible by access to regional logistics hubs also known as bazaars, which have been instrumental for marketing their products.

# Policy Implications continued ...

- The termination of the Kazakh simplified customs procedure for individuals raising the specter of costly adjustment in Kyrgyzstan ***should not prompt the government of Kyrgyzstan to take any measures that would increase the cost of adjustment and add to uncertainty faced by the private sector.***
  - It should avoid taking any actions that would raise this cost through, for instance, the collection of VAT on imports destined for re-exports.
  - It should rather consider ***measures that would make even friendlier the environment for logistics activities in Kyrgyzstan.*** The demand for re-exported Chinese consumer goods in other countries, including Kazakhstan, should drive the adaptation in the Kyrgyz sector serving as a re-exports platform rather than changes in Kyrgyz import regime that had had such positive impact on employment and incomes.
  - The accession to the BKR CU would fall short of addressing the adjustment problem - a possible venue is to start ***negotiating special rules on cross-border trade within the radius of 30 kilometers on both sides of the border with Kazakhstan.***
  
- Our analysis indicated ***the emergence of a vibrant, internationally competitive, garments sector also in Tajikistan.*** It is difficult to assess whether this is really the case as Tajikistan does not report detailed foreign trade to the United Nations. One should therefore conduct a survey of this sector in Tajikistan as it would be important—drawing on the lessons from the experience of Kyrgyzstan—to develop measures further facilitating its development.

# Final observation

- The emergence of the BKR CU creates both challenge and opportunity.
- The challenge is to reduce hassle cost of doing business and improve business climate.
- The opportunity is to have access to a larger market subject to lower levels of competition from non-CIS suppliers (in its Kazakhstan's area).
- Both call for in-depth analyses to design well policies